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No. 80-1251

THE SUPREME COURT OF THE UNITED STATES
October Term, 1980

United States of America, Petitioner

v.

Vogel Fertilizer Company, Respondent

On Writ of Certiorari
To The United States Court of Claims

BRIEF OF AMICUS CURIAE

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Statutes and Regulations:

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Section 11(d)--pages 3, 15.

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Section 1551—pages 16, 18, 21, 22, 23.

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Other Authorities:

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BRIEF OF AMICUS CURIAE

INTEREST OF THE AMICUS CURIAE

The amicus curiae are four corporations organized and existing under the laws of the State of Colorado where they are engaged in the business of banking. The amicus curiae will be referred to as the "Banks." The names and locations of the Banks are as follows:

The Minnequa Bank of Pueblo	Pueblo, Colorado
The Bank of Aspen	Aspen, Colorado
First National Bank of Durango	Durango, Colorado
Bank of Monte Vista	Monte Vista, Colorado

In 1974 and 1975, the number of shareholders of each Bank ranged from 18 to 50. Control of each Bank rested with Mahlon T. White and Helen T. White who together owned, directly or indirectly, a majority (but not 80% or more) of the single class of stock of each Bank. A group of five or fewer individuals, including the Whites, owned at least 80% of the outstanding stock of each of the Banks. However, because the minority shareholders varied from Bank to Bank, the members of the 80% ownership group differed from Bank to Bank. Only Mahlon T. White and Helen T. White were

members of the 80% ownership group of each Bank. Other shareholders owned stock in only one Bank.

In computing their respective tax liabilities for 1974 and 1975, the Banks each utilized a full surtax exemption pursuant to Section 11(d) of the Internal Revenue Code (the "Code"). The Commissioner of Internal Revenue determined that the Banks constituted component members of two separate brother-sister controlled groups of corporations, as defined by Section 1563(a)(2) of the Code and Section 1.1563-1(a)(3) of the Treasury Regulations. Therefore, the Banks were paired into two controlled groups, and the two Banks in each group were required to share a single surtax exemption pursuant to Section 1561(a)(1) of the Code.

On March 6, 1979, each of the Banks filed a petition before the United States Tax Court, contending that it was entitled to a single surtax exemption for taxable years 1974 and 1975 and praying for relief consistent with that contention. The captions of the cases and their United States Tax Court docket numbers are set forth below:

The Minnequa Bank of Pueblo	2866-79
The Bank of Aspen	2867-79
First National Bank of Durango	2868-79
Bank of Monte Vista	2869-79

Following the filing of answers by the Commissioner of Internal Revenue as respondent, the parties in each case filed a joint motion to consolidate the four cases, which motion was granted by the United States Tax Court on February 25, 1980. The parties agreed to and filed a stipulation of facts, and briefs were filed on April 10, 1980. The United States Tax Court has not yet

rendered an opinion on the issue raised by the Banks.

The Banks believe that the issue presented in their case before the United States Tax Court is identical to the issue now before this Court. The question presented is whether, for purposes of the 80% test under Section 1563(a)(2)(A) of the Code, a person must own stock in each and every corporation of the alleged brother-sister controlled group of corporations. Accordingly, the Banks have sought and obtained the written consent of the parties to this case to file a brief of an amicus curiae, pursuant to Rule 36.2 of the Supreme Court Rules.

SUMMARY OF ARGUMENT

The United States Tax Court already has decided this issue six times in favor of the taxpayer. Recently, the Tax Court analysis was affirmed by the Fifth Circuit Court of Appeals and was followed by the United States Court of Claims. These prior holdings are correct, and Respondent should prevail in this case, because (i) the language of the statute itself supports Respondent, (ii) the legislative history of the statute supports Respondent, and (iii) policy considerations support Respondent.

ARGUMENT

RESPONDENT IS NOT A MEMBER OF A BROTHER-SISTER CONTROLLED GROUP OF CORPORATIONS WITHIN THE MEANING OF SECTION 1563(a)(2) OF THE INTERNAL REVENUE CODE.

The facts of the case before this Court are adequately set forth in Petitioner's brief and will not be repeated. The legal issue presented arises in Section 1563(a)(2) of the Code. As amended in 1969, Section 1563(a)(2) provides that a brother-sister controlled group consists of:

> Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own . . . stock possessing--
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

Because of the majority stockholding of Arthur Vogel in Vogel Fertilizer Company and Vogel Popcorn Company, the parties evidently agree that the 50% test set forth in Section 1563(a)(2)(B) was met in the taxable years in issue. The parties disagree only as to the proper application of the 80% test of Section 1563(a)(2)(A). Respondent contends that the five or fewer persons who own 80% or more of the stock in one alleged member of a controlled group must be the same persons who own 80 percent or more of the stock in the other alleged member. Because Richard Crain owned stock only in the

Respondent and because his interest in that corporation exceeded 20%, the 80% test could not have been met with respect to Respondent and Vogel Popcorn Company.

Petitioner relies on Treasury Reg. § 1.1563-1(a)(3). Contrary to the legislative history of Section 1563, the regulations do not require that each of the same five or fewer persons own at least 80% of the voting stock or value of shares of each corporation. Instead, they make the sweeping interpretation that the 80% ownership test is met where any five or fewer persons "singly or in combination" own stock of the two or more corporations.

On at least six occasions, the United States Tax Court has declared the regulation relied on by Petitioner invalid. The issue was first decided in January 1976 in Fairfax Auto Parts of Northern Virginia,

Inc. v. Commissioner, 65 T.C. 798 (1976), a decision reviewed by the entire court. In July 1976, the Tax Court followed its Fairfax decision in T.L. Hunt, Inc. v. Commissioner, 35 T.C. Memo 966 (1976). In January 1977, the Fourth Circuit, in a per curiam opinion, reversed the Fairfax decision, and in October 1977, this Court denied certiorari in the case. Fairfax Auto Parts, Inc. v. Commissioner, 548 F. 2d 501 (4th Cir. 1977), cert. denied, 98 S. Ct. 300 (1977). In light of the Fourth Circuit reversal, the Tax Court reconsidered the validity of the regulation in Charles Baloian v. Commissioner, 68 T.C. 620 (1977), but in a reviewed opinion held again in favor of the taxpayer. In the face of a subsequent appellate court reversal [T.L. Hunt, Inc. of Texas v. Commissioner, 562 F.2d 532 (8th Cir. 1977)] the Tax Court

adhered to its reasoning in Fairfax three more times. Delta Metalforming Co., Inc. v. Commissioner, 37 T.C. Memo 1485 (1978); Allen Oil Company, Inc. v. Commissioner, 38 T.C. Memo 355 (1979); Davidson Chevrolet Company v. Commissioner, 39 T.C. Memo 299 (1979). The Allen Oil decision subsequently was reversed by the Second Circuit. Allen Oil Company, Inc. v. Commissioner, 80-1 U.S.T.C. ¶ 9156 (2d Cir., January 11, 1980). However, on December 8, 1980, the Fifth Circuit became the first Court of Appeals to affirm the Tax Court and hold that a person must own stock in each member of an alleged brother-sister controlled group to satisfy the 80% test under Section 1563(a)(2)(A). Delta Metalforming Co., Inc. v. Commissioner, 632 F.2d 442 (5th Cir. 1980), petition for cert. pending, No. 80-1499 (filed March 4, 1981). The Delta

Metalforming decision came soon after the United States Court of Claims decision giving rise to the case before this Court. See Vogel Fertilizer Company v. United States, 634 F.2d 497 (Ct. Cl. 1980).

The Tax Court's position, as affirmed by the Fifth Circuit and followed by the Court of Claims, is correct for three basic reasons:

I. THE LANGUAGE OF SECTION 1563 ITSELF SUPPORTS RESPONDENT.

The language of the statute itself is not susceptible to the sweeping interpretation of the statute set forth in the regulation. The significant words of the statute with respect to the issue are: "if 5 or fewer persons . . . own . . . (A) at least 80% . . . of each corporation, and (B) more than 50% . . . of each corporation, taking into account the stock ownership of

each such person only to the extent such stock ownership is identical with respect to each such corporation."

First, it is clear that the phrase "5 or fewer persons" is the conjunctive subject of both the 80% test and the 50% test. This sentence structure in itself specifies that the same five or fewer persons are required for both tests. Second, the term "such person" in the 50% test is a direct reference back to the same "5 or fewer persons" designated for consideration in connection with the 80% test. Finally, the term "each such person" in the 50% test, which refers back to the "5 or fewer persons" specified in the 80% test, must mean that each of those persons and not just some of those persons who are counted as owning stock for the 80% test also must own stock for purposes of the 50% test. The

regulation ignores this thrust of the language of the statute by including for purposes of the 80% test persons who cannot be included in meeting the 50% test because they do not own stock in all the corporations involved.

Moreover, an analysis of the manner in which the language of Section 1563(a)(2)(A) was in fact amended in 1969 makes it all the more evident that the regulation represents a totally impermissible construction of the statute. Prior to the 1969 amendment, Section 1563(a)(2) provided that two or more corporations constituted a controlled group if "at least 80% . . . of each of the corporations is owned . . . by one person." [Emphasis supplied.] With respect to the 80% test, the 1969 amendment merely increased the size of the ownership group in order to reach situations where "5

or fewer persons . . . own . . . at least 80% . . . of each corporation." [Emphasis supplied.]

Since the original definition was read as requiring that each corporation in the group be owned by the same person, the mere increase in the size of the ownership group from one to five can be taken only as authority for now permitting the 80% test to be satisfied where a larger number of the same persons comprise the ownership group of each corporation. Yet the regulation reaches well beyond this authority.

II. THE LEGISLATIVE HISTORY OF SECTION 1563 SUPPORTS RESPONDENT.

The surtax exemption of Section 11(d) was designed to stimulate the formation of capital by providing a tax incentive for incorporators of small businesses. A lower tax rate was applied to the first

dollars earned by a corporation. The exemption, however, was subject to possible abuse through the use of the multi-corporate structure. A corporate owner could gain the advantage of two or more surtax exemptions, simply by operating his business through two or more corporations. Prior to the enactment of Section 1561 in 1964 the Commissioner had various ways to attack such abuses. Through Sections 269, 1551, 482, 61, and the common law theories of "assignment of income," "disregard of corporate entity," and "sham transaction," the Commissioner could minimize the procurement of additional surtax exemptions through the use of multiple corporations. The efficacy of these devices was limited, however, because the Commissioner was usually required to demonstrate a "tax avoidance

purpose" as a prerequisite to their application.

The Revenue Act of 1964 for the first time provided a mechanical limitation upon the abilities of "multiple corporations" to enjoy the benefits of multiple surtax exemptions. Under Sections 1561 and 1563, if the percentage ownership tests of either a parent-subsidiary controlled group or a brother-sister controlled group were met, the entire group of corporations was required to share a single surtax exemption without further inquiry into whether the structure was motivated by tax avoidance or legitimate business purposes. As noted above, the 1964 Act defined a brother-sister controlled group as two or more corporations where <u>one</u> individual owned 80% or more of the stock of each.

Finding that the 80% ownership test by one individual was easily circumvented, the Treasury proposed to broaden the definition of brother-sister controlled group contained in Section 1563. The Tax Reform Proposals presented by the Treasury in April 1969 urged that the definition of a brother-sister controlled group should be changed "so that a group of corporations would constitute a brother-sister controlled group if (1) the same five or fewer persons own at least 80% of the voting stock or value of shares of each corporation, and (2) these five or fewer individuals own more than 50% of the voting power or value of shares of each corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. This definition is the same as that under Section 1551." [Emphasis partly

supplied.] Hearings on Tax Reform, Tax Reform Proposals Presented by Representatives of the Treasury Department, 91st Congress, 1st Session, p. 194 (referred to as "Hearings"). Congress adopted the new definition as recommended. In light of the foregoing statement, the regulation clearly is improper, since under the regulation the "same" persons are not required to own 80% of "each" corporation in the group.

But the Treasury Proposal went even further. It also stated that the 80% test would be satisfied "if the group of five or fewer persons as a whole owns at least 80% . . . of each corporation." [Emphasis supplied.] Hearings, supra. By contrast, the regulation does not even remotely contemplate that the "whole" group will own 80% of each corporation.

Finally, the illustrative examples that were offered conclusively establish that the original Treasury Proposal was not submitted with the regulation in mind:

> For example [the 80% test but not necessarily the 50% test] is met whether one person owns 80% of the voting stock of each corporation, four persons each own 20% of the voting stock of each corporation, or one person owns 60% of the voting stock of one corporation and 40% of another, and another person owns 40% of the voting stock of the first and 60 percent of the second.

Hearings, supra. Each of the examples indicate a requirement of common ownership in each of the corporations. If a broader interpretation of the statute had been intended, appropriate examples surely would have been supplied in the Treasury Proposal.

While neither the House nor the Senate Committee Report offers as full an explanation of the 80% test as the Treasury

Proposal (see H. Rep. 91-413, 1969-3 C.B. 262, 384; S. Rep. 91-552, 1969-3 C.B. 509-10), they contain no language that is contradictory. Moreover, the Supplemental House Report reiterates that the new stock ownership test of Section 1563(a)(2) "would be the same test employed in Section 1551(b)(2) of the Code," a statement that first appeared in the Treasury Proposal. H. Rep. 91-413, 1969-3 C.B. 384.

Section 1551(b)(2) and the regulations thereunder require that the same persons who meet the 50% test also meet the 80% test. In Reg. § 1.1551-1(f)(2), Example (2), A owns all of the stock of X Corporation and 60% of Y Corporation. The ownership of the remaining 40% of Y Corporation is not disclosed. In a later year, A acquires an additional 20% of Y Corporation and only thereafter do the

corporations meet the 50% and 80% ownership tests. The result in this example shows that the intent of the regulation is to require all persons whose stock ownership is considered in meeting the 80% test to own some stock in each corporation. Since A owned all of the stock of X Corporation, only his ownership in Y Corporation is deemed relevant for this purpose. Likewise, in Example (3) of Reg. § 1.1551-1(f)(2), Section 1551 is not deemed applicable to a situation in which individuals A and B each own 50% of X Corporation and A owns all the stock of Y; however, when B buys 50% of the stock of Y, Section 1551 is held to be applicable to X and Y.

The test under Section 1551(b)(2) is phrased, in all relevant respects, in precisely the same language as the amendment to Section 1563(a)(2). Since it is clear

that Section 1551(b)(2) applies only where precisely the same five or fewer persons compose the 80% ownership group of each of the two corporations involved, it is evident that Congress believed it was adopting the Respondent's interpretation of Section 1563(a)(2)(A), rather than the interpretation contained in the regulation.

III. POLICY CONSIDERATIONS SUPPORT RESPONDENT.

The purpose of Section 1563 was to replace the subjective tests of Sections 269, 482, and 1551 with an objective definitional test. The statute sought to deter the use of two or more corporations primarily for tax purposes where the nontax results would be generally the same if only one corporation were used. This was a recognition that purpose is still part of the rationale, but the statute seeks to test

for purpose by an objective standard--several corporations controlled like one. In the situation where the individuals control one of the corporations but not the other, the nontax results differ decidedly from the use of one corporation. The 50% test, which assures common control of all corporations involved, is the test which assures that the statute will be applied to any multiple corporation situation which has the control features resembling one corporation. Thus, the 50% test--the control test--actually tests for the most salient feature of the improper tax use of several corporations and must be viewed as the primary test under the statute.

If the 50% test is the primary test, then the drafters of the statute must have felt something in addition to control was required. The function of the 80% test

is to require that the five or fewer persons in control have an aggregate ownership which represents substantially the entire financial interest in all corporations involved. Congress could have required that the five persons in control own 100% of the equity in each corporation. However, this would have made it easy to avoid the section by placing a nominal amount of stock in outside hands. On the other hand, Congress could have been satisfied with anything over 50% as the requisite financial interest for those in control. But Congress went further, requiring in addition to control that those persons in control have a substantial financial interest in the corporations, i.e., 80%.

A financial interest test is needed because the conduct sanctioned by the statute is the exercise of common control by a small group of persons over more than one

corporation (the 50% test) for the purposes of their own substantial financial interest in those corporations (the 80% test). Since this is the function of the 80% test, the 80% stock ownership requirement of the statute cannot be met with stock owned by a person who is outside the control group. To interpret the statute so that the 80% test can be met by persons having ownership in only one corporation ignores the obvious relationship between the 50% test and the 80% test, i.e., the exercise of control by persons with a substantial financial interest in the corporations.

This point was emphasized in the dissenting opinion by Judge Webster in the Court of Appeals for the Eighth Circuit in T. L. Hunt, supra:

> . . . It is not the smallness of the number of persons in each company that triggers § 1563; it is the sameness of that small number.

> The 80% financial interest requirement is meaningless unless it is the <u>same</u> group of five or fewer persons that own 80% of each company within the controlled group. It is this requirement of "economic entity" which is entirely eviscerated by Reg. § 1.1563-1(a)(3).

If Congress had intended that there be only a simple test of 50% ownership, the language of the statute would have more clearly expressed this intent. Although the 80% test may in fact be a secondary test, it is important insofar as it includes the common investment interests of the shareholders in order to determine whether or not two or more corporations are essentially the same entity in determining the stockholders' financial interest. The logic and rationale supporting the concept of one economic enterprise was carried over in the expansion of the statute in 1969 when the 80% test was

expanded from one person to five or fewer persons.

There is no sound policy supporting the interpretation of the statute that the regulation espouses. The regulation offers the following example of its interpretation of the statute:

> Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Indi-	CORPORATIONS					Indentical
viduals	P	Q	R	S	T	Ownership
A	60%	60%	60%	60%	100%	60%
B	40%					
C		40%				
D			40%			
E				40%		
TOTAL	100%	100%	100%	100%	100%	60%

> Corporations P, Q, R, S, and T are members of a brother-sister controlled group. See Reg. § 1.1563-1(a)(3)(ii), Example (1).

Suppose A also had owned 60% of a sixth corporation in which F was the other shareholder. Why should a controlled group be deemed to include the four corporations, owned 60% each by A and 40% owned by B, C, D, and E respectively--but not a sixth corporation owned 60% by A and 40% by F? Because the 80% test of the regulation is limited in its application to corporations owned 80% or more by "five or fewer persons," the sixth corporation presumably would not be included in the controlled group since F is the sixth person. But is the sixth corporation any less commonly owned and controlled than the other corporations? The 80% test as interpreted by the regulation draws a totally artificial line by arbitrarily excluding a corporation with a pattern of ownership that is identical to every corporation in the

group. From a policy standpoint, either all corporations owned 60% by A and 40% by other persons should be covered by the statute, or none of them should be.

In the regulation's example, none of the persons making up the ownership group have any common control or ownership except for A. Reading the eighty percent test in such a manner insures not that the same persons own a substantial financial interest in each corporation but merely that each corporation will be a closely held corporation. Since the purpose of the section 11(d) surtax exemption evidently was to benefit closely held corporations, such a result is untenable.

Moreover, the regulation's interpretation of the statute is troublesome for equitable reasons. It seems unfair that the Treasury should be allowed to so

dramatically expand the impact of a statute by its regulations when, in every one of the examples that it presented to Congress during the hearings, it failed to include a pattern of ownership similar to that which was ultimately adopted by it in the regulations.

Finally, the Treasury interpretation of the statute will lead to situations where persons who own stock in only one corporation will be surprised to find that their corporations are part of a controlled group and that their single holdings are contributing to that result. The possibility that upset the Tax Court majority in Fairfax, supra, was as follows:

> Individual A owns 55% of corporation X and individual B owns 45% thereof. If A were independently to enter into a second business in corporate form the corporations would be component members of a controlled group. We cannot believe that Congress intended to

surprise B with such a result. 65 T.C., at 805.

A similarly unfavorable situation would occur if A already owned one business and then formed a second unrelated business with B. If A owned fifty-five percent of the stock of the second business and B owned forty-five percent of the stock, under the regulation a brother-sister controlled group would be formed. The law therefore would dictate the absurd proposition that before B goes into business with A, he must investigate all of A's other ho dings to make sure that A and B together are not running two or more businesses as a single economic entity.

This situation is exactly that in which Richard Crain, the minority shareholder of Respondent, finds himself. Under Petitioner's interpretation of the statute, Mr. Crain causes Respondent and Vogel

Popcorn Company to be members of a controlled group of corporations, even though he owns stock only in Respondent. As a result, Mr. Crain's corporation must share a corporate surtax exemption with another corporation even though he has no interest in that other corporation.

The Tax Court has heard these arguments many times in the past. Even in the face of appellate court reversals, it has stood firm in requiring the Treasury to refrain from lawmaking and to interpret accurately the will of Congress. The overwhelming majority of the commentators has applauded the Tax Court's adherence to reason and Congressional intent. See Bonovitz, "Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test," 28 Tax Lawyer 511 (1975); Libin and Abramowitz, "Multiple

Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in Temporary Regulations," 3 Tax Adviser 326 (1971); Thomas, "Brother-Sister Multiple Corporations--The Tax Reform Act of 1969 Reformed by Regulation," 28 Tax Law Review 65 (1972); Nathanson, "Fairfax Auto Parts, Inc. v. Commissioner: Definitional Requirements of the Multiple Corporation for Purposes of Exclusion from Surtax Exemptions," 32 Univ. of Miami L. Rev. 461 (1977); Weisman, "Brother-Sister Controlled Corporations: On and Off the Road to the Supreme Court with an Edsel," 56 Taxes 475 (1978); Committee Recommendations, Committee on Affiliated and Related Corporations, Section of Taxation, American Bar Association, 27 Tax Lawyer 813 (1974). Recently, courts of appeal have joined the Tax Court to rebuff the Treasury's intrusion

into the legislative process. With so much authority behind it, this Court should follow the Tax Court decision in Fairfax, supra, and hold summarily for Respondent.

CONCLUSION

For the reasons stated, the judgment of the Court of Claims should be affirmed.

Respectfully submitted,

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